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No. 79-1013

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

WILLIAM RUBIN,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR BOSSIER BANK & TRUST COMPANY AS AMICUS CURIAE

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INTEREST OF AMICUS CURIAE

Bossier Bank & Trust Company ("BBT") is a Louisiana banking corporation whose business is regulated and supervised by the Louisiana State Banking Department and the Federal Deposit Insurance Corporation. BBT is interested in the present case because this Court's opinion may affect *First National Bank of Las Vegas, New Mexico* v. *Estate of Milton B. Russell, et al.*, No. 80-1401 in the United States Court of Appeals for the Fifth Circuit, in which BBT is an appellee. *First National Bank* is an appeal from the order of the United States District Court for the Southern District of Texas granting summary judgment for BBT and the other defendants in a private action for damages brought by First National Bank of Las Vegas. The district judge determined that a repurchase transaction involving fictitious United States treasury notes did not constitute a purchase or sale of a security for purposes of § 10(b) of the Securities Exchange Act of 1934. BBT will support the district court's judgment on appeal by contending that the transaction in question was essentially a loan in which the treasury notes were to be pledged as collateral. Therefore, BBT supports petitioner's argument in the present case that a pledge of securities is not a "sale" for purposes of the federal securities laws.

SUMMARY OF ARGUMENT

The Court should construe the term "sale" in light of the purposes of the antifraud provisions of the federal securities laws. Neither the language nor the legislative history of these statutes provides any indication that Congress intended to bring within their scope the pledging of securities as collateral for commercial loans. There is no significant public policy that would be served by extending the protection of federal securities laws to secured lenders in this context.

The Court should not rely upon the passage of "title" for determining whether there has been a sale of securities that are pledged as collateral for a loan. Instead, a test of economic reality should be employed for determining whether a transaction is essentially a transfer of ownership or a secured loan.

ARGUMENT

(1) The Court Should Adopt the Position of the Fifth and Seventh Circuits and Hold that a Pledge of Securities as Collateral for a Loan Is Not a "Sale" for Purposes of the Antifraud Provisions of the Federal Securities Laws.

The question in the present case is whether the pledge of securities as collateral for a loan is a "sale" within the meaning of § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a). But the resolution of this question will undoubtedly affect the interpretation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. The courts of appeals have uniformly held that the definitions of "sale" and "purchase or sale" in the antifraud provisions of these two acts should be given the same interpretation with regard to pledges. *Lincoln National Bank* v. *Herber,* 604 F.2d 1038, 1040-41 (7th Cir. 1979); *Mansbach* v. *Prescott, Ball & Turben,* 598 F.2d 1017, 1028-29 (6th Cir. 1979); *National Bank of Commerce* v. *All American Assurance Co.,* 583 F.2d 1295, 1298 (5th Cir. 1978); *Mallis* v. *FDIC,* 568 F.2d 824, 829-30 (2d Cir. 1977), *cert. dismissed,* 435 U.S. 388 (1978).

In this context, the Solicitor General's argument based on the literal definition of "sale" in the 1933 Act, 15 U.S.C. § 77b(3), is disingenuous. *See* Brief for the United States on Petition for Certiorari, at 9. It is true that the statutory

definition includes every "disposition of a security or interest in a security" and that a pledge could be described as creating an "interest" in a security even though it does not transfer ownership. But the opposite conclusion would have to be drawn from the literal definition of "sale" in the 1934 Act, 15 U.S.C. § 78c(a)(14), which includes only a "contract to sell or otherwise dispose of" a security, and makes no mention of the transfer of a mere "interest" in a security. In summary, the word "interest" in the definition of "sale" in the 1933 Act cannot be given controlling significance unless the Court is prepared to treat pledge transactions differently under the 1934 Act.[1]

The legislative histories of the definitions of the terms "sale" and "purchase or sale" in the two acts contain no evidence of an intention to include pledge transactions. *See* J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, vol. 1, p. xix & vol. 4, p. xv (1973). In 1935, only one year after the enactment of the Securities Exchange Act, Congress specifically listed pledges within the definition of "sale" in the Public Utility Holding Company Act, 15 U.S.C. § 79b(23). Thus it appears that Congress was well aware of the practice of pledging securities at the time it drafted the 1933 and 1934 acts and simply did not include such pledges within the definition of a "sale" for purposes of those acts.

A common sense approach based on the purposes of the two acts supports the view that they were not intended to cover pledge transactions. The evils toward which these acts were directed are not involved where securities are used as collateral for a loan. The practices toward which the legislation was aimed involved the issuance of worthless

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[1] For an argument that the 1934 Act imposes less liability for pledge transactions than the 1933 Act, see Note, *A Pledge of Stock in a Commercial Loan: "Purchase or Sale" under the Securities Exchange Act of 1934?*, 1979 ARIZ. ST. L.J. 669, 675-77.

new securities and transactions designed to influence the price at which securities sold in subsequent markets by affecting (or appearing to affect) the forces of supply and demand.[2] A pledge of securities, however, is a non-market transaction which has no effect upon the market price of securities. The pledge of securities as collateral for a loan primarily affects the market for loanable funds, a market that the drafters of the 1933 and 1934 acts did not purport to regulate except for changes in margin requirements.

Moreover, it is unnecessary to give the federal securities laws an expansive interpretation to provide secured lenders with protection against fraud. A secured lender, unlike the the outright purchaser or seller of securities, always has a right of action on the debt itself. State laws, including the Uniform Commercial Code, extensively regulate secured transactions and the remedies for default. *See Lincoln National Bank* v. *Herber,* 604 F.2d 1038, 1044 (7th Cir. 1979). Federal law also provides criminal sanctions for making false statements to most financial institutions in connection with applications for loans or pertaining to the security therefor. 18 U.S.C. § 1014.[3] In summary, secured

[2] The 1933 Act was designed to protect the investor in securities. *See* S. Rep. No. 47, 73rd Cong., 1st Sess. (1933); H.R. Rep. No. 85, 73rd Cong., 1st Sess. (1933); 77 Cong. Rec. 2983 (1933) (remark of Sen. Fletcher). The 1934 Act was designed to remedy several perceived problems and manipulative practices, including (1) the manipulation of the securities market by members of the securities exchanges, (2) naked speculation encouraged by low margin requirements, and (3) the exploitation of uninformed investors by the use of speculative pools, wash sales and matched orders, and other devices. Message from the President – Regulation at Securities Exchanges, S. Doc. No. 132, 73rd Cong., 2nd Sess. (1934); 78 Cong. Rec. 7690 (1934) (remarks of Rep. Cooper); H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 2-5, *contained in,* 78 Cong. Rec. 7702-03 (1934).

[3] The statute provides criminal penalties for one who "knowingly makes any false statement . . . for the purpose of influencing in any way the action of," *inter alia,* a federally-insured financial institution, "upon any loan . . . or the acceptance, release or substitution of security therefor . . . ." 18 U.S.C. § 1014.

lenders are well protected without coverage by the federal securities laws.

Applying the antifraud provisions of the securities laws to the pledge of securities as collateral for commercial loans could also have far-reaching consequences on the credit markets. Corporate finance transactions involving a pledge of securities would probably have to include extensive disclosures similar to those required for the registration of an issuance of those securities.[4] The requirement of such disclosure statements would increase the cost of commercial borrowing and serve no useful purpose. A commercial lender is generally sophisticated and can always require, as a prerequisite to granting a loan, such disclosures as it believes would be useful. The effect of extending securities law coverage to this situation would be to require additional disclosures that lenders do not want and borrowers should not have to pay for.

(2) The Court Should Employ a Test of "Economic Reality" for Determining When a Transaction is a Secured Loan Rather than a Sale of Securities.

The first point of this brief argues that the pledge of securities as collateral for a loan should not be regarded as a sale for purposes of the antifraud provisions of federal securities law. Amicus curiae suggests further that economic reality rather than technical notions of "title" should govern application of this holding if adopted by the Court.

It is a commonplace that substance rather than form should control the application of the antifraud provisions of the federal securities laws. *United Housing Foundation* v. *Forman,* 421 U.S. 837, 849 (1975); *Tcherepnin* v. *Knight,*

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[4] As this Court well knows, cautious participants in securities transactions make exhaustive disclosures to avoid subsequent litigation based on the theory that there was a failure to disclose some material fact.

389 U.S. 332, 336 (1967). In this regard, for example, a transaction that has the effect of a sale of securities should be treated as a sale, even though it is pretextually structured as a pledge. *Herpich* v. *Wallace* 430 F.2d 792, 810-11 (5th Cir. 1970); *see National Bank of Commerce* v. *All American Assurance Co.,* 583 F.2d 1295, 1300 (5th Cir. 1978).

On the other hand, a pledge of securities should not be retroactively transformed into a sale just because of a subsequent default in the loan. *But cf. McClure* v. *First National Bank,* 497 F.2d 490, 495-96 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975), *criticized in United States* v. *Gentile,* 530 F.2d 461, 467 n.6 (2d Cir.), *cert. denied,* 426 U.S. 936 (1976). As a practical matter, such a holding would largely negate the benefits of the rule advocated in part one of this brief. A secured creditor is most likely to allege securities fraud when the debtor has defaulted. If the creditor could then retroactively transform the pledge into a sale by foreclosing, securities law coverage could be easily obtained in most cases.[5] A better approach would be to hold that the transaction is characterized as a pledge or sale on the basis of its structure at the time it is entered into.

Another potential pitfall associated with undue reliance upon the concept of "title" involves the interplay of federal securities law and the state law of secured transactions. No useful purpose would be served by requiring in each

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[5] Of course, the foreclosure sale of the securities by the pledgee could itself be a "sale" to which the federal securities laws apply. *See* SEC v. Guild Films Co., 279 F.2d 485 (2d Cir.), *cert. denied,* 364 U.S. 819 (1960). Amicus curiae does not support this rule, since it imposes severe burdens on foreclosing lenders when the collateral consists of unregistered securities. But, in any event, a subsequent foreclosure sale should not be held retroactively to transform the original secured loan transaction into a "sale" as well.

case an inquiry into the metaphysics of "title" or its passage under the applicable state laws. Such an approach would create a potential for inconsistent applications of federal law, depending upon the way the transaction in question is treated under the law of the various states.[6] State law on secured transactions involving securities is very complex.[7] The Court risks unintended consequences if it adopts a mechanical rule for determining when a pledge of securities must be regarded as a "sale." A better approach would be to hold simply that a transaction which in substance involves the use of securities as collateral for

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[6] The laws of the various states are not uniform on the subject of secured interests in securities. In most states, the law concerning this subject is based on Article 9 of the Uniform Commercial Code. The common law "pledge" is perpetuated in Section 9-305, which provides for the perfection of a security interest by the possession of certain kinds of collateral, subject to the exceptions for nonpossessory perfection in section 9-304(4) & (5).

In 1977, however, Articles 8 and 9 were revised, and a few states have adopted these revisions. A major reason for the 1977 revision was to create a body of law to govern uncertificated securities. A new section 8-321 was added to govern the creation, perfection, and termination of security interests in all securities, both certificated and uncertificated. For uncertificated securities a new mechanism, "registration of pledge," was created in section 8-108 for evidencing a security interest, as an alternative to the more conventional procedure of registering a transfer to the secured party.

Finally, paragraph 3 of the official comment to section 8-102 makes clear that the definition of a "security" for purposes of the UCC is not coextensive with the definitions of this term in the federal securities laws. The creation of security interest in unconventional securities would thus continue to be governed by Article 9 or pre-Code law even in those states that have adopted the 1977 revisions.

For a discussion of some choice of law problems created by the old and new version of Articles 8 and 9, see R. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS 490-91 (2d ed. 1980).

[7] *See e.g.*, Coogan, *Security Interests in Investment Securities under Revised Article 8 of the Uniform Commercial Code*, 92 HARV. L. REV. 1013 (1979).

a loan does not constitute a "sale" of the collateral to the lender for purposes of the federal securities laws.

The use of an economic reality test is consistent with this Court's decisions on other questions involving the applicability of federal securities law. *See, e.g., Teamsters* v. *Daniel,* 439 U.S. 551, 558-59 (1979); *United Housing Foundation* v. *Forman,* 421 U.S. 837, 851-52 (1975). Such a test would promote the uniform application of the federal law in this respect, based upon an understanding of the important but limited purposes of that law.

CONCLUSION

For the reasons stated in this brief, amicus curiae prays that this Court reverse the judgment of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on this 27th day of June, 1980, three copies of the foregoing Brief for Bossier Bank & Trust Company as Amicus Curiae were mailed, postage prepaid, to counsel for petitioner and counsel for respondent as follows: Louis Bender, Bender & Frankel, 225 Broadway, New York, NY 10007; Solicitor General, Department of Justice, Washington, D.C. 20530. Copies of this brief have also this day been mailed, postage prepaid, to all counsel of record in *First National Bank of Las Vegas, New Mexico* v. *Estate of Milton B. Russell, et al.*, No. 80-1401 in the United States Court of Appeals for the Fifth Circuit. I further certify that all parties required to be served have been served.

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